2006

Understanding SAS No. 112 and evaluating control deficiencies : a companion to SAS No. 112, Communicating internal control related matters identified in an audit; Audit risk alerts

Ahava Goldman

AUDIT RISK ALERTS

Understanding SAS No. 112 and Evaluating Control Deficiencies

A Companion to SAS No. 112, Communicating Internal Control Related Matters Identified in an Audit

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

AICPA®

AUDIT RISK ALERTS

Understanding SAS No. 112 and Evaluating Control Deficiencies

A Companion to SAS No. 112, Communicating Internal Control Related Matters Identified in an Audit

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

AICPA®

Notice to Readers

This Audit Risk Alert, prepared by the AICPA staff, is intended to help you understand and implement the requirements of Statement on Auditing Standards (SAS) No. 112, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1, sec. 325).

This publication is an *Other Auditing Publication* as defined in AU section 150, *Generally Accepted Auditing Standards.* Other Auditing Publications have no authoritative status; however, they may help the auditor understand and apply SASs.

If an auditor applies the auditing guidance included in an *Other Auditing Publication*, he or she should be satisfied that, in his or her judgment, it is both appropriate and relevant to the circumstances of his or her audit. The auditing guidance in this document has been reviewed by the AICPA Audit and Attest Standards staff and published by the AICPA and is presumed to be appropriate. This document has not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA.

The author gratefully acknowledges the contributions of the AICPA Technical Issues Committee in the development of this Audit Risk Alert.

Ahava Goldman, CPA
Technical Manager
Audit and Attest Standards

1 2 3 4 5 6 7 8 9 0 AAG 0 9 8 7 6

Table of Contents

Understanding SAS No. 112 and Evaluating Control Deficiencies—A Companion to SAS No. 112

Introduction

In May 2006, the AICPA Auditing Standards Board (ASB) issued Statement on Auditing Standards (SAS) No. 112, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1, sec. 325). SAS No. 112 establishes standards and provides guidance on communicating matters related to an entity's internal control over financial reporting (internal control) identified in an audit of financial statements. SAS No. 112 supersedes SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325), as amended.

The new SAS is applicable whenever an auditor expresses an opinion on financial statements (including a disclaimer of opinion) and is effective for audits of financial statements for periods ending on or after December 15, 2006. This Audit Risk Alert provides an overview of the requirements of SAS No. 112 as well as case studies that illustrate how control deficiencies may be evaluated for severity.

Why SAS No. 112 Was Issued

The Sarbanes-Oxley Act of 2002 and the issuance of Public Company Accounting Oversight Board (PCAOB) Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements*, (AICPA, *PCAOB Standards and Related Rules*, AU sec. 320), created considerable interest in management's responsibility for internal control and the auditor's responsibility for bringing certain internal control related matters to management's attention in an audit of financial statements. Auditing Standard No. 2 only applies to audits conducted in accordance with PCAOB standards. Generally, this means that Auditing Standard No. 2 applies to audits of public companies (issuers[1]). However, the issuance of Auditing Standard No. 2 created a desire on the part of nonissuers to better understand and evaluate control deficiencies.

The ASB revised SAS No. 60 because it believed there was a need to reconsider and clarify the internal control matters that auditors must communicate to their audit clients. The ASB recognized that auditors were perceived to be inconsistent in communicating the significant deficiencies and material weaknesses identified in prior audits that had not yet been remediated. The ASB also concluded that generally accepted auditing standards (GAAS) should require auditors to communicate these matters in writing, rather than continue to provide auditors with the option of communicating them orally. To achieve greater consistency with Auditing Standard No. 2, the ASB decided that certain terms and definitions in SAS No. 60 should be replaced with the corresponding terms and definitions in Auditing Standard No. 2. Finally, the ASB concluded that it would be beneficial to incorporate some of the guidance in Auditing Standard No. 2 on evaluating control deficiencies that would be applicable to audits of nonissuers.

Overview of the Standard

In general, SAS No. 112 provides guidance to enhance your ability to identify and evaluate control deficiencies during an audit, and then communicate to management and those charged with governance those deficiencies that you believe are *significant deficiencies* or *material weaknesses.*

1. An *issuer* is an entity subject to the provisions of the Sarbanes-Oxley Act of 2002 or the rules of the Security and Exchange Commission (SEC). Nothing in the PCAOB's rules precludes a CPA from conducting an audit of a nonissuer in accordance with PCAOB standards and stating so in the auditor's report.

The standard has two unconditional requirements:

- The auditor must evaluate identified control deficiencies and determine whether those deficiencies, individually or in combination, are significant deficiencies or material weaknesses.
- The auditor must communicate, in writing, significant deficiencies and material weaknesses to management and those charged with governance. This communication includes significant deficiencies and material weaknesses identified and communicated to management and those charged with governance in prior audits but not yet remediated.

Change From SAS No. 60

Your communication to management and those charged with governance must be in writing.

Even if you communicated specific significant deficiencies and material weaknesses in previous years, as long as those deficiencies continue to exist , you must continue to communicate them.

The new standard provides guidance on evaluating the severity of control deficiencies identified in an audit.

Identifying Control Deficiencies

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis:

- A deficiency in *design* exists when (*a*) a control necessary to meet the control objective is missing or (*b*) an existing control is not properly designed so that, even if it operates as designed, the control objective is not always met.
- A deficiency in *operation* exists when a properly designed control does not operate as designed or when the person performing the control does not possess the necessary authority or qualifications to perform the control effectively.

The Auditor's Responsibility for Identifying Control Deficiencies

When conducting an audit of historical financial statements, you are not required to perform procedures to identify control deficiencies. However, during the course of the audit, you may become aware of deficiencies in the design or operation of the entity's internal control. You may identify control deficiencies at any point in your audit, for example, when you are:

- Obtaining an understanding of the entity's internal control,
- Assessing the risks of material misstatement of the financial statements, due to error or fraud,
- Performing further audit procedures to respond to assessed risk, or
- Communicating with management or others (for example, internal auditors or governmental authorities).

Your awareness of control deficiencies will vary with each audit and will be influenced by the nature, timing, and extent of audit procedures performed, as well as other factors. The results of your substantive procedures may cause you to reevaluate your earlier assessment of internal control.

Evaluating Control Deficiencies

Change From SAS No. 60

The term *reportable condition* is no longer used. The terms *significant deficiency* and *material weakness* are used to describe control deficiencies that must be communicated to management and those charged with governance.

A control deficiency may be considered just a deficiency. More severe deficiencies are *significant deficiencies*, and the most severe deficiencies are *material weaknesses*.

Definitions of Significant Deficiency and Material Weakness

A *significant deficiency* is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles (GAAP) such that there is more than a remote[2] likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected.

A *material weakness* is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected.

The Evaluation Process

Change From SAS No. 60

You must evaluate identified control deficiencies and determine whether these deficiencies, individually or in combination, are significant deficiencies or material weaknesses. In making your evaluation, you link identified control deficiencies to actual or potential financial statement misstatements.

Additional guidance is provided in SAS No. 112 on evaluating control deficiencies to determine whether they are significant deficiencies or material weaknesses.

2. The term *remote likelihood* as used in the definitions of the terms *significant deficiency* and *material weakness* has the same meaning as the term *remote* as used in Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies*. Paragraph 3 of FASB Statement No. 5 states:

   > When a loss contingency exists, the likelihood that the future event or events will confirm the loss or impairment of an asset or the incurrence of a liability can range from probable to remote. This Statement uses the terms *probable, reasonably possible*, and *remote* to identify three areas within that range, as follows:
   >
   > a. *Probable*. The future event or events are likely to occur.
   >
   > b. *Reasonably possible*. The chance of the future event or events occurring is more than remote but less than likely.
   >
   > c. *Remote*. The chance of the future event or events occurring is slight.

   Therefore, the likelihood of an event is "more than remote" when it is at least reasonably possible.

You must evaluate the control deficiencies that you have identified and determine whether these deficiencies, individually or in combination with other control deficiencies, rise to the level of significant deficiencies or material weaknesses. The significance of a deficiency in internal control depends on the *potential* for misstatement in the financial statements being audited, not just on whether a misstatement has actually occurred. If you identify a control deficiency but you have not identified an actual misstatement related to that deficiency, you cannot automatically conclude that the deficiency is not a significant deficiency or a material weakness. If you have identified a misstatement, you should consider the potential for further misstatement in the financial statements being audited.

Factors to Consider

The factors that you should consider when evaluating control deficiencies are:

- Likelihood, and
- Magnitude

Likelihood refers to the probability that a control, or combination of controls, could have failed to prevent or detect a misstatement in the financial statements being audited. If, in your professional judgment, it is at least reasonably possible that a misstatement could have occurred because of a missing control, or because of the failure of a control or combination of controls, then the likelihood is *more than remote.* The existence of a design weakness, in and of itself, is sufficient to conclude that there is more than a remote likelihood that the control would not have been effective. Likewise, if a deficiency resulted in an actual misstatement, you will be better able to determine the likelihood, because it actually happened.

Magnitude refers to the extent of the misstatement that could have occurred, or that actually occurred, since misstatements include both potential and actual misstatements. The magnitude of a misstatement may be inconsequential, more than inconsequential but less than material, or material, as shown in the following:

Inconsequential ⟶ More than inconsequential ⟶ Material

A misstatement is *inconsequential* if a reasonable person would conclude, after considering the possibility of further undetected misstatements, that the misstatement, either individually or when aggregated with other misstatements, would clearly be immaterial to the financial statements. If a reasonable person would not reach such a conclusion regarding a particular misstatement, that misstatement is more than inconsequential.

The difference between a significant deficiency and a material weakness is the magnitude of the misstatement that could have occurred because of the failure of the control to prevent or detect a misstatement. If the magnitude of the actual or potential misstatement is less than material but more than inconsequential, the control deficiency is a significant deficiency. If the misstatement would have been material to the financial statements, the control deficiency is a material weakness. In this evaluation, it does not matter if a misstatement did not actually occur; what is relevant is the potential for misstatement.

You should consider qualitative and quantitative factors in determining whether a misstatement or potential misstatement is more than inconsequential. For example, for the purpose of evaluating control deficiencies, a potential misstatement that is less than 20 percent of overall financial statement materiality may be considered inconsequential, before considering qualitative factors. However, a potential misstatement that is less than 20 percent of overall financial statement materiality may be considered more than inconsequential as a result of qualitative factors; for example, a potential misstatement that would change a loss into income, or result in violation of a loan covenant.

The following table summarizes how you consider the significance of a deficiency to determine whether it is a control deficiency, a significant deficiency, or a material weakness.

Magnitude of Misstatement That Occurred, or Could Have Occurred	*Likelihood of Misstatement*	
	More Than Remote	*Remote*
Quantitatively or qualitatively material	**Material weakness**	**Control deficiency but not a significant deficiency or a material weakness**
More than inconsequential but less than material	**Significant deficiency but not a material weakness**	**Control deficiency but not a significant deficiency or a material weakness**
Inconsequential (i.e., clearly immaterial)	**Control deficiency but not a significant deficiency or a material weakness**	**Control deficiency but not a significant deficiency or a material weakness**

Multiple Control Deficiencies

Multiple control deficiencies that affect the same financial statement account balance or disclosure increase the likelihood of misstatement and may, in combination, constitute a significant deficiency or material weakness, even though such deficiencies are individually insignificant. Accordingly, you should evaluate individual control deficiencies that affect the same account balance, disclosure, relevant assertion, or component of internal control to determine whether they collectively result in a significant deficiency or material weakness.

Mitigating Effects of Compensating Controls

When a control deficiency has been identified, management and the auditor should also evaluate the possible mitigating effects of compensating controls. Only those compensating controls that you have tested and evaluated as part of the financial statement audit can be considered for mitigation. A compensating control is a control that limits the severity of a control deficiency and prevents it from rising to the level of a significant deficiency or, in some cases, a material weakness. Compensating controls operate at a level of precision, considering the possibility of further undetected misstatements, which would result in the prevention or detection of a misstatement that is more than inconsequential or material to the financial statements. Although compensating controls mitigate the effects of a control deficiency, they do not eliminate the control deficiency.

For example, consider a situation in which there is a lack of segregation of duties within the accounts payable function in an owner-managed entity. As a compensating control, the owner reviews the supporting documentation for all disbursements exceeding one thousand dollars. As part of your audit, you could test this compensating control and determine whether it operates effectively for the purpose of mitigating the effects of the control deficiency (lack of segregation of duties) in the accounts payable function. Although the control deficiency still exists—the review does not eliminate the lack of segregation of duties—the significance of the deficiency may be mitigated by the compensating control so that it is not a significant deficiency or a material weakness.

The Prudent Official Test

When you evaluate the significance of a deficiency, the last step in your evaluation is to conclude whether a prudent official having knowledge of the same facts and circumstances, would agree with your classification of the deficiency. Although the term *prudent official* is not defined in the standard, the concept is that an auditor should "stand back" and take another objective look at the severity of the deficiency much as would a regulator or someone from an oversight agency. You are being asked to consider whether a prudent official (knowing what you know about the facts and circumstances, the likelihood and magnitude of the potential misstatement, and the other controls that you tested) would agree with your conclusion that a deficiency is not a significant deficiency or that a significant deficiency is not a material weakness. Would you be comfortable defending your conclusion? If not, you should reconsider your evaluation of the significance of the deficiency looking through the skeptical lens of a prudent official. Because a prudent official is cautious, the prudent official test is used only to increase the severity of a control deficiency and not to justify a decrease in the severity.

SAS No. 112 includes (1) a list of areas in which control deficiencies ordinarily are at least significant deficiencies, and (2) a list of indicators that a control deficiency should be regarded as at least a significant deficiency and a strong indicator of a material weakness. A material financial statement misstatement that was not identified by management is a strong indicator of a material weakness.

SAS No. 112 also contains an appendix that provides examples of circumstances that may be control deficiencies, significant deficiencies, or material weaknesses. This appendix revises and expands on the examples contained in the appendix to SAS No. 60. The following are some of the items included in the appendix:

- Inadequate design of internal control over the preparation of the financial statements being audited
- Employees or management who lack the qualifications and training to fulfill their assigned functions; for example, the corporate controller lacks the knowledge and skill to apply GAAP in recording the entity's financial transactions or preparing its financial statements
- Inadequate design of information technology (IT) general and application controls
- Inadequate documentation of the components of internal control
- Inadequate design of monitoring controls that assess the design and operating effectiveness of the entity's internal control over time

Communication Requirements

Change From SAS No. 60

Significant deficiencies and material weaknesses must be communicated in writing to management and those charged with governance as part of each audit. This communication includes significant deficiencies and material weaknesses that were communicated to management and those charged with governance that have not yet been remediated.

The communication is best made by the report release date, but should be made no later than 60 days following the report release date.

The illustrative written communications in SAS No. 60 have been revised.

Form of Communication

You must communicate *in writing* to management and those charged with governance.

Content of Communication

You must communicate all control deficiencies that you evaluated as significant deficiencies and material weaknesses. If you communicated significant deficiencies and material weaknesses in previous audits and those deficiencies have not yet been remediated, you must communicate them again. Management and those charged with governance may already know about certain deficiencies and may have made a conscious decision to accept that degree of risk because of cost or other considerations. Management is responsible for that decision. You are responsible for communicating significant deficiencies and material weaknesses, regardless of management's decision. As long as the significant deficiencies and material weaknesses exist, you must continue to communicate them.

You should not issue a written communication stating that no significant deficiencies were identified during the audit because of the potential for misinterpretation of the limited degree of assurance provided by such a communication.

SAS No.112 contains an illustrative communication that encompasses the requirements of the standard. In addition, SAS No. 112 contains an illustrative communication that may be used when the auditor has been requested to advise management and those charged with governance of the fact that no material weaknesses were identified. Also illustrated is a paragraph to be added to the auditor's communication if, for the benefit of a regulator, management's response to the auditor's communication of significant deficiencies and material weaknesses is included in a document with the auditor's written communication.

Timing of Communication

Best practice is to issue your written communication by the report release date. You should issue your communication no later than 60 days following the report release date.

For some matters, early communication to management or those charged with governance may be important. If you decide to communicate certain identified significant deficiencies and material weaknesses during the audit, the communication may be oral. However, all significant deficiencies and material weaknesses that you communicated orally during the audit must be communicated in writing to management and those charged with governance.

How the Revisions Will Affect Practice

As you gain a better understanding of what needs to be communicated to management and those charged with governance, you may find that there will be more control deficiencies that you:

- Identify as significant deficiencies and material weaknesses, and
- Communicate to management and those charged with governance.

You may emphasize and therefore spend more time evaluating identified control deficiencies than you did in the past.

Discussions With Management and Others

The new requirements of SAS No. 112 may change perceptions regarding the auditor's role in the client's internal control. You may have to explain to your clients that you, the auditor, *cannot* be a part of their internal control. Only the client—not the auditor—can correct control deficiencies. However, a CPA firm other than the auditor can be part of a client's internal control. This may raise new questions regarding the role of outsourcing in achieving management's internal control objectives.

You may wish or be called upon to hold discussions with management and other users of your written communication, such as regulators, to explain why the nature and extent of the internal control matters communicated to management and those charged with governance are different from the matters communicated in prior years. One reason is that the criteria have changed because of the introduction of the term *significant deficiencies* and its definition as well as a new definition of *material weaknesses*. Another reason is that you have to include significant deficiencies and material weaknesses, identified and communicated in previous years, in your written communication as long as these deficiencies have not been remediated. You may need to explain to management and other users that you are required to inform them of the significant deficiencies and material weaknesses every year as long as the deficiencies still exist.

You may also need to hold discussions with management and other users who ask how you were able to express a clean opinion on the financial statements when material weaknesses in internal control were present. You may wish to explain that your audit was designed to provide reasonable assurance that the financial statements are free from material misstatements. Internal control should be designed to prevent or detect material misstatements. As previously stated, the auditor cannot be part of a client's internal control. You can express a clean opinion on the financial statements even though material weaknesses in internal control are present, because you performed sufficient procedures and obtained appropriate audit evidence to afford reasonable assurance that the financial statements are free from material misstatement. However, these procedures do not *correct* control deficiencies; the deficiencies in internal control could still result in a material misstatement not being prevented or detected by the client.

Issues for Audits of Smaller Entities

One issue that may arise in audits of smaller entities is the possibility of increased costs as a result of the auditor's time spent documenting his or her evaluation of internal control and evaluating identified control deficiencies.

Another issue that may cause concern is the extent to which you (as the auditor) may be involved in the drafting of an entity's financial statements. It is a strong indication of material weakness in internal control if your client has ineffective controls over the preparation of their financial statements such that client controls are absent or controls are not effective in preventing or detecting material misstatements in the preparation of financial statements, including the related footnotes. Although the auditor can propose adjustments and assist in assembling or drafting the financial statements, the auditor cannot establish or maintain the client's controls, including monitoring ongoing activities, since doing so would impair independence.[3] How an auditor responds to a client's internal control weakness, in terms of designing and carrying out auditing procedures, does not affect or mitigate a client's internal control weakness. Just as an auditor's response to detection risk is independent of the client's control risk, so too the auditor's response to a control weakness does not change the control weakness.

Possible Opportunities. The new requirements of SAS No. 112 introduce possible opportunities for you. You can help clients evaluate the cost/benefit implications of improving their internal control, including training their personnel to be more knowledgeable. You can also teach your clients how to develop a risk assessment approach to designing internal control.

Examples

SAS No. 112 includes examples of factors that impact on the consideration of likelihood and magnitude.

Likelihood

The following are examples of factors that may affect the likelihood that a control, or combination of controls, could fail to prevent or detect a misstatement:

3. See ET section 101-3, *Performance of Nonattest Services,* Rule 101, *Independence* (AICPA, *Professional Standards,* vol. 2, ET sec. 101.05).

- The nature of the financial statement accounts, disclosures, and assertions involved. For example, suspense accounts and related party transactions involve greater risk
- The susceptibility of the related assets or liability to loss or fraud
- The subjectivity and complexity of the amount involved and the extent of judgment necessary to determine that amount
- The cause and frequency of any known or detected exceptions relating to the operating effectiveness of a control
- The interaction or relationship of the control with other controls
- The interaction of the control deficiency with other control deficiencies
- The possible future consequences of the deficiency

Magnitude

Factors that may affect the magnitude of a misstatement that could result in a deficiency or deficiencies in controls include but are not limited to the following:

- The financial statement amounts or total of transactions exposed to the deficiency
- The volume of activity in the account balance or class of transactions exposed to the deficiency in the current period or expected in future periods

Generally, the recorded amount is the maximum amount by which an account balance or total of transactions can be overstated. However, because of the potential for unrecorded amounts, there is no upper limit on the amount of potential understatement. For example, if there is a control deficiency over the completeness of accounts payable, and the recorded amount is $200,000, the most the amount could be overstated is $200,000. But the most the amount could be understated cannot be known.

The following are examples of control deficiencies and how their likelihood and magnitude might be considered:

- *Failure to obtain required authorization for a valid disbursement.* In this case, you may consider the likelihood of misstatement that could result from recording an unauthorized disbursement, using the factors listed above.
- *A deficiency in controls over revenue transactions that results in a financial statement misstatement.* In this case, the likelihood of misstatement is more than remote because a misstatement actually occurred. You may consider the potential for misstatement in amounts greater than the identified misstatement.

Control Deficiencies, Significant Deficiencies, or Material Weaknesses

The following paragraphs describe circumstances that may be control deficiencies, significant deficiencies, or material weaknesses.

Deficiencies in the design of controls may include the following:

- Inadequate design of internal control over the preparation of the financial statements being audited
- Inadequate design of internal control over a significant account or process
- Inadequate documentation of the components of internal control
- Insufficient control consciousness within the organization, for example, the tone at the top and the control environment
- Absent or inadequate segregation of duties within a significant account or process
- Absent or inadequate controls over the safeguarding of assets (This applies to controls that the auditor determines would be necessary for effective internal control over financial reporting.)

- Inadequate design of information technology (IT) general and application controls that prevent the information system from providing complete and accurate information consistent with financial reporting objectives and current needs
- Employees or management who lack the qualifications and training to fulfill their assigned functions (For example, in an entity that prepares financial statements in accordance with GAAP, the person responsible for the accounting and reporting function lacks the skills and knowledge to apply GAAP in recording the entity's financial transactions or preparing its financial statements.)
- Inadequate design of monitoring controls used to assess the design and operating effectiveness of the entity's internal control over time
- The absence of an internal process to report deficiencies in internal control to management on a timely basis

Failures in the operation of internal control may include the following:

- Failure in the operation of effectively designed controls over a significant account or process; for example, the failure of a control such as dual authorization for significant disbursements within the purchasing process
- Failure of the information and communication component of internal control to provide complete and accurate output because of deficiencies in timeliness, completeness, or accuracy; for example, the failure to obtain timely and accurately consolidating information from remote locations that is needed to prepare the financial statements
- Failure of controls designed to safeguard assets from loss, damage, or misappropriation
- Failure to perform reconciliations of significant accounts; for example, accounts receivable subsidiary ledgers are not reconciled to the general ledger account in a timely or accurate manner

- Undue bias or lack of objectivity by those responsible for accounting decisions; for example, consistent understatement of expenses or overstatement of allowances at the direction of management
- Misrepresentation by client personnel to the auditor (an indicator of fraud)
- Management override of controls
- Failure of an application control caused by a deficiency in the design or operation of an IT general control

Note that the third circumstance in the preceding list, failure of controls designed to safeguard assets from loss, damage, or misappropriation, may need careful consideration before it is evaluated as a significant deficiency or material weakness. For example, assume that a company uses security devices to safeguard its inventory (preventive controls) and also performs periodic physical inventory counts (detective control) timely in relation to its financial reporting. Although the physical inventory count does not safeguard the inventory from theft or loss, it prevents a material misstatement of the financial statements if performed effectively and timely. Therefore, given that the definitions of material weakness and significant deficiency relate to the likelihood of misstatement of the financial statements, the failure of a preventive control such as inventory tags will not result in a significant deficiency or material weakness if the detective control (physical inventory) prevents a misstatement of the financial statements. Material weaknesses relating to controls over the safeguarding of assets would only exist if the company does not have effective controls (considering both safeguarding and other controls) to prevent or detect a material misstatement of the financial statements.

Significant Deficiencies

Deficiencies in the following areas ordinarily are at least significant deficiencies in internal control:

- Controls over the selection and application of accounting principles that are in conformity with GAAP; having sufficient expertise in selecting and applying accounting principles is an aspect of such controls

- Antifraud programs and controls
- Controls over nonroutine and nonsystematic transactions
- Controls over the period-end financial reporting process, including controls over procedures used to enter transaction totals into the general ledger; initiate, authorize, record, and process journal entries into the general ledger; and record recurring and nonrecurring adjustments to the financial statements.

Material Weaknesses

Each of the following circumstances is an indicator of a control deficiency that should be regarded as at least a significant deficiency and a strong indicator of a material weakness in internal control:

- Ineffective oversight by those charged with governance of the entity's financial reporting and internal control, or an ineffective overall governance structure
- Restatement of previously issued financial statements to reflect the correction of a material misstatement (The correction of a misstatement includes misstatements due to error or fraud but not restatements to reflect a change in accounting principle to comply with a new accounting principle or a voluntary change from one GAAP to another.)
- Identification by the auditor of a material misstatement in the financial statements for the period under audit that was not initially identified by the entity's internal control (This includes misstatements involving estimation and judgment for which the auditor identifies likely material adjustments and corrections of the recorded amounts, which is a strong indicator of a material weakness even if management subsequently corrects the misstatement.)
- An ineffective internal audit function or risk assessment function at an entity for which such functions are important

to the monitoring or risk assessment component of internal control, such as for very large or highly complex entities

- For complex entities in highly regulated industries, an ineffective regulatory compliance function (This relates solely to those aspects of the ineffective regulatory compliance function for which associated violations of laws and regulations could have a material effect on the reliability of financial reporting. When evaluating the severity of such control deficiencies, the auditor should consider whether the entity has controls in place to monitor the impact on the financial statements of laws and regulations relevant to the conduct of the entity's business, and should evaluate the severity of the absence of such controls based on the entity's potential to misstate obligations that may arise from such laws or regulations.)
- Identification of fraud of any magnitude on the part of senior management (The auditor has a responsibility to plan and perform procedures to obtain reasonable assurance about whether the financial statements are free of material misstatement caused by error or fraud.[4] However, for the purposes of evaluating and communicating deficiencies in internal control, the auditor should evaluate fraud of any magnitude—including fraud resulting in immaterial misstatements—on the part of senior management, of which he or she is aware.)
- Failure by management or those charged with governance to assess the effect of a significant deficiency previously communicated to them and either correct it or conclude that it will not be corrected (See paragraph 23 of SAS No. 112 for communication requirements in these circumstances.)

4. AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1), provides guidance on the auditor's responsibilities for planning and performing the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement whether caused by error or fraud.

- An ineffective control environment (Control deficiencies in various other components of internal control could lead the auditor to conclude that a significant deficiency or material weakness exists in the control environment.)

Evaluation Questions

In evaluating the severity of a control deficiency, the first step is to determine whether the deficiency is at least a significant deficiency. Some questions to ask yourself when making this determination include:

- Is the likelihood that a misstatement of any magnitude could occur and not be detected by the client's controls at least reasonably possible?
- Is the magnitude of a potential misstatement inconsequential or less than inconsequential to the financial statements? A misstatement is inconsequential if a reasonable person would conclude, after considering the possibility of further undetected misstatements, that the misstatement, either individually or when aggregated with other misstatements, would clearly be immaterial to the financial statements.
- Are there complementary or redundant controls that were tested and evaluated that achieve the same control objective?
- Are there compensating controls that were tested and evaluated that limit the magnitude of a misstatement of the financial statements to inconsequential?

If the answers to these questions are all *no*, then the deficiency is at least a significant deficiency. If the answer to any question is *yes*, before concluding that the control deficiency is *not* at least a significant deficiency ask yourself: Would prudent officials, having my knowledge of the facts and circumstances, agree with my conclusion that the deficiency is *not* at least a significant deficiency?

If a prudent official would consider the control deficiency to be at least a significant deficiency, then you would conclude that the deficiency is at least a significant deficiency.

The next step is to assess whether the deficiency is a material weakness. Some questions to ask yourself in making this determination include:

- Is the magnitude of the potential misstatement less than material to the financial statements?
- Are there compensating controls that were tested and evaluated that limit the magnitude of a misstatement of the financial statements to less than material but more than inconsequential?
- Does additional evaluation result in a judgment that the likelihood of a material misstatement of the financial statements is remote?

If the answers to these questions are all *no*, then the deficiency is a material weakness. If the answer to any question is *yes*, before concluding that the deficiency is *not* a material weakness, ask yourself, Would prudent officials, having my knowledge of the facts and circumstances, agree with my conclusion that the deficiency is a significant deficiency and not a material weakness, considering the financial statements?

If a prudent official would consider the control deficiency to be a material weakness, then you would conclude that the deficiency is a material weakness.

Case Studies

This section contains case studies, that each highlight a particular control deficiency. Each case study contains a description of the control deficiencies, and an analysis of the assessment of the severity of the control deficiency. The control deficiencies discussed are:

- Lack of segregation of duties
- Lack of client expertise in financial accounting and reporting
- Inventory-related control deficiencies

- Failure to review modifications of standard sales contracts to evaluate their effect on the timing and amount of revenue recognition
- Fraud involving cash
- Control testing exceptions

Control Deficiency 1: Lack of Segregation of Duties

Situation 1

Your client is a small nonprofit organization that has only one person in charge of the accounting and reporting functions. Through your understanding of controls over cash disbursements, you observe a lack of segregation of duties, which is a control deficiency. In assessing the severity of the control deficiency, you consider whether there are complementary, redundant, or compensating controls.

Additional Facts. Through obtaining your understanding of internal control, you've learned that a board member signs all checks, reviewing invoices that support the disbursement before signing. The signed checks are returned to the client to be mailed. The bank sends the bank statement directly to the board member, who reviews the bank statement and returned checks. The bank statement is then given to the client for reconciliation.

Discussion. Your assessment of the severity of this control deficiency would be based on the effectiveness of the compensating controls performed by the board members. The compensating controls do not eliminate the deficiency but may mitigate the effects of the control deficiency.

If the board member does not perform a review of the bank statement and the returned checks, verifying that all the checks have the appropriate signature and that the check payee and amount have not been altered, you might determine that the compensating control over disbursements is not effective in achieving the control objective and, therefore, there is a material weakness.

If the board member reviews only returned checks over a certain dollar amount, you might conclude that the compensating control is effective in preventing or detecting a material misstatement of cash and, therefore, this may be considered a significant deficiency because the magnitude of the reasonably possible misstatement is less than material but more than inconsequential.

However, if the board member examines the returned checks for the appropriate signature and alterations, you might conclude that the compensating control is effective in preventing or detecting an unauthorized disbursement, making the likelihood of a misstatement remote; therefore, this is only a control deficiency and not a significant deficiency or material weakness.

Situation 2

Your client is a small business that has only one person in charge of the accounting and reporting functions. The bookkeeper has been with the company for many years. It is common for the owner to leave signed, blank checks with the bookkeeper, "in case of emergencies" when the owner is gone. The owner does not perform any oversight procedures. The owner has you, the auditor, perform quarterly interim procedures. The owner believes the auditors are a substitute for his lack of oversight. One of the auditor's quarterly procedures is to review the bank reconciliation, which is prepared by the bookkeeper.

Discussion. Because the auditor cannot be part of the client's internal control, your interim procedures, including your review of the bank reconciliations, are not compensating controls. Should the bookkeeper betray the owner's trust, the magnitude of a potential misstatement could reasonably be expected to be material. In your judgment, you believe that a reasonable person would conclude that there is more than a remote possibility that a misstatement could occur and not be caught by the owner. Thus, the lack of segregation of duties and the lack of oversight would be considered material weaknesses.

Control Deficiency 2: Lack of Client Expertise in Financial Accounting and Reporting

In situations 3, 4, and 5, you provide assistance to your client in the drafting of the financial statements but, as the auditor, remain independent under Ethics Interpretation 101-3, *Performance of*

Nonattest Services under Rule 101, *Independence* (AICPA, *Professional Standards*, vol. 2, ET sec. 101.05). That is, you post client-approved adjusting entries to the trial balance and assist in the drafting of the financial statements from the trial balance. You are not responsible for preparing and approving adjusting entries.

Situation 3

Your client's controller is fairly skilled and is able to perform most of the functions necessary to prepare the financial statements. However, the company does not maintain a fixed asset ledger. Rather, you maintain a fixed asset ledger for them on your computer using "off-the-shelf" fixed asset software. From this software package, you are able to print for the controller a projected depreciation schedule, a gain and loss calculation report based on cost, and sales information provided to you by the controller and a final deprecation and fixed asset listing at year-end. The controller provides adequate supervision of the depreciation calculation so there is no conflict with Interpretation 101-3. The book and tax depreciation calculation affects depreciation expense for book purposes and also the calculation of deferred taxes. The client could purchase a depreciation program but has concluded it is more cost effective to rely on you for these records.

In most years, the controller provides you with a year-end adjustment if adjustments hadn't already been made to the general ledger. However, in this particular year, the controller has been preoccupied with other tasks and asks you to calculate the year-end depreciation adjustment and gain or loss on sale adjustment. The adjustment is a material adjustment. Because you propose the adjustment, you need to consider whether there is a control deficiency.

Discussion. In this situation, you would begin by considering the likelihood that a misstatement would not be detected. Because the auditor cannot be part of a client's internal controls, the controls that exist in your CPA firm to perform the calculations cannot be taken into account in considering whether the client has a control deficiency. Instead, you must consider what controls the client has to detect a misstatement. Based on only these facts, your judgment is that the client has the competency to perform the accounting function but has chosen to outsource the depreciation closing function this year. Therefore, as long as the client is reviewing and taking responsibility for the depreciation and related calculations, and possesses the skills and competencies to prevent, detect, and correct potential misstatements, you would determine that there is not a control deficiency. If the client is not able to prevent, detect, and correct a misstatement, then you would determine that there is a control deficiency.

Situation 4

This client has an accounting manager who requests that you assist in drafting the financial statements and notes to the financial statements. However, prior to signing the representation letter, the accounting manager obtains the financial statement grouping schedules and the schedules documenting the calculation of amounts included in the notes to the financial statements, and reviews and approves these schedules. In addition, the accounting manager obtains a current disclosure checklist from the AICPA and reviews and answers the checklist to ensure propriety and completeness of the footnotes. The financial statements are also read, revised, and approved by both the accounting manager and the owner.

Discussion. Based only on the facts presented, there is not an observed control deficiency. You would need to further understand whether the client's controls are designed appropriately and operating effectively, and that would be dependent on the competence and expertise of the client's accounting manager. In assessing this situation, you would first consider the likelihood of a material misstatement in the presentation and disclosure of the financial statements, including the related footnotes, occurring and not being detected by the accounting manager. If you determine that the accounting manager and owner lack the necessary accounting expertise to detect a misstatement, then that would represent a control deficiency that would need to be evaluated. However, you might conclude that, despite the accounting manager asking you to assist in drafting the financial statements and footnotes, they (the accounting manger and owner) do possess the necessary accounting expertise to prevent, detect, and correct a potential misstatement in the financial statements or notes; therefore, you would not have a control deficiency.

Situation 5

At this client, you taught the bookkeeper to record cash receipts and disbursements as well as the adjusting journal entries needed to record accounts receivable and payable at year-end. The bookkeeper follows your directions and prepares a draft of the year-end financial statements from a format you provided, including relevant recurring disclosures.

During your audit, you notice that the owner acquired a new delivery truck that cost $50,000—an amount that is material to the company's financial statements—and financed the acquisition through the dealer's finance company. You determine that the financing lease should be capitalized. The bookkeeper has recorded the monthly cash payments for the truck to the dealership but has not recorded the initial fixed asset and related liability (the owner had told her that he was leasing the truck). In discussing the new truck with the bookkeeper, you further discover that the owner was involved in a collision on the last day of the year while driving the truck and the company's insurance covered only a small portion of the damages. The financial statements do not reflect the capital lease and the related liability, nor does it reflect the expense and liability for the damages in excess of the company's insurance.

Discussion. Based only on these facts, you determine that there is a control deficiency that did not detect, prevent, or correct the misstatements in the client's drafted financial statements. Because you caught this error, your judgment is that the likelihood that the financial statements would be misstated is more than remote, and the magnitude of the misstatement is material. You are not an employee of the company and cannot be part of the company's internal control. The company did not have anyone on staff with sufficient expertise to properly analyze the lease and record the fixed asset acquisition, and the bookkeeper was not sufficiently knowledgeable to know that she needed help in recording these events. In this case, the quality of the financial statements was not a result of the company's internal control. As such, you determine that the entity has a material weakness.

If the bookkeeper had called you for guidance about how to account for these events, before recording them, your conclusion most likely would have been different. A discussion with the client about a technical issue is not, in and of itself, an indication of a weakness in the company's internal control. The client's ability to detect a potential misstatement, and ability to gain the necessary competence, are factors you would consider in your understanding of the entity's internal control.

Control Deficiency 3: Inventory-Related Control Deficiencies

Situation 6

Your client is a large car dealership. There is a lack of good controls over tracking inventory quantities of dealership parts, but a physical inventory is taken at the end of every quarter. A parts manager was selling dealership parts, not recording the sales, and keeping the receipts. Although the amount of the writedown needed to reflect actual inventory was not material to the financial statements, management became aware of the fraud when the parts manager confessed under questioning.

Discussion. The purpose of your evaluation is to assess the likelihood and potential magnitude of a financial statement misstatement, not the likelihood and potential magnitude of a loss due to fraud. Because the preventive controls tracking inventory quantities are weak, the client is relying on detective controls—physical inventory—to catch any potential misstatement. From a design perspective, detective controls are seldom as effective as preventive controls, as evidenced by the fact that the client suffered a loss as a result of the weak preventive controls. However, the physical inventory was effective at detecting the loss, so that the financial statements were not materially misstated. Because you would consider the effect of compensating controls in your assessment of the severity of the control deficiency, you would conclude that the preventive control weakness is mitigated by the detection control to the extent that there is not a significant deficiency or material weakness in internal control over financial reporting.

Although the fraud did not result in a *material* misstatement of the financial statements, the fraud is evidence of a control deficiency in internal control over the safeguarding of assets against unauthorized acquisition, use, or disposition. SAS No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, sec. 316), requires that whenever the auditor has determined that there is evidence that fraud may exist, that matter should be brought to the attention of an appropriate level of management. Therefore, you may wish to include this misappropriation (and other risks of fraud that you have identified) in your written communication of significant deficiencies and material weaknesses.

Control Deficiency 4: Failure to Review Modifications of Standard Sales Contracts to Evaluate Their Effect on the Timing and Amount of Revenue Recognition

Situation 7

Your client uses a standard sales contract for most transactions. Individual sales transactions are not material. Sales personnel are permitted to modify the terms of the sales contract, including shipping terms. Accounting personnel review the terms of the sales contracts for significant or unusual modifications but do not review changes in the standard shipping terms. The changes in the standard shipping terms could cause a delay in the timing of revenue recognition. Management reviews gross margins on a monthly basis and investigates any significant or unusual relationships. In addition, management reviews the reasonableness of inventory levels at the end of each accounting period. There have been a limited number of instances in which revenue was inappropriately recorded, but the related amounts have not been material.

Discussion. Based on only these facts, you determine that a control deficiency exists in the design of the entity's controls because there are no controls over a sales person's ability to modify the standard sales contract. In evaluating the severity of this control deficiency, you consider the likelihood and potential magnitude of a financial statement misstatement resulting from this deficiency. The magnitude could reasonably be expected to be more than inconsequential. However, the magnitude would be expected to be less than material, because individual sales transactions are not material and the compensating controls that mitigate the deficiency, which operate monthly and at the end of each financial reporting period, increase the likelihood that a material misstatement will be detected. Furthermore, the risk of material misstatement is limited to revenue recognition errors related to shipping terms, as opposed to broader sources of error in revenue recognition. However, the compensating controls are designed to detect only material misstatements. The controls do not effectively address the detection of misstatements that are more than inconsequential but less than material, as evidenced by situations in which transactions that were not material were improperly recorded. Therefore, there is a more than remote likelihood that a misstatement that is more than inconsequential but less than material could occur. Based on only these facts, you would conclude that this deficiency is a significant deficiency.

Situation 8

Your client has a standard sales contract, but sales personnel frequently modify the terms of the contract. Certain modifications can affect the timing and amount of revenue recognized. Individual sales transactions frequently are material to the entity, and the gross margin can vary significantly for each transaction.

Through your understanding of internal control necessary to plan the audit, you determine that the entity has a design deficiency in that the entity does not have procedures in place for accounting personnel to regularly review modifications to the terms of sales contracts. Although management reviews gross margins on a monthly basis, the significant differences in gross margins for individual transactions make it difficult for management to identify potential misstatements. Improper revenue recognition has occurred in the past, and the amounts have been material.

Discussion. The magnitude of a financial statement misstatement resulting from this control deficiency would reasonably be expected to be material because individual sales transactions are frequently material, and gross margin can vary significantly with each transaction (which would make compensating controls based on a reasonableness review ineffective). Additionally, improper revenue recognition has occurred, and the amounts have been material. Therefore, the likelihood of material misstatements occurring is more than remote. Because, taken together, the magnitude and likelihood of misstatement of the financial statements resulting from this internal control deficiency is material, you determine that this deficiency is a material weakness.

Situation 9

The entity has a standard sales contract; however, sales personnel frequently modify the terms of the contract. Sales personnel frequently grant unauthorized and unrecorded sales discounts to customers without the knowledge of the accounting department. These discounts are taken by customers, deducted from the amount paid, and recorded as outstanding balances in the accounts receivable aging. Although the amounts of these discounts are individually insignificant, they are material in the aggregate and have occurred consistently during the past few years.

Discussion. The magnitude of a financial statement misstatement resulting from this deficiency would reasonably be expected to be material, because the frequency of occurrence allows insignificant amounts to become material in the aggregate. The likelihood of a material misstatement of the financial statements resulting from this internal control deficiency is more than remote (even if the client fully reserved for the uncollectible accounts) due to the likelihood of material misstatement of the gross accounts receivable balance. Therefore, your judgment is that this deficiency represents a material weakness.

Control Deficiency 5: Fraud Involving Cash

Situation 10

Your client is a small not-for-profit organization that receives most donations by check from corporate donors. Some donations are made in cash. Cash donations are not material to the financial statements. As a result of your understanding of internal control, you notice that there are no controls over cash receipts. In planning your audit, you identify this as a fraud risk and you perform additional auditing procedures relative to cash receipts. Through inquiry, you learn that someone may be stealing cash. You notify management and as a result of performing certain audit tests you discover evidence that indicates that an employee was pocketing the cash and that cash donations were not being recorded.

Discussion. Your judgment is that the likelihood of a misstatement is more than remote, as the fraud has occurred. The magnitude of the potential financial statement misstatement resulting from this deficiency would reasonably be expected to be more than inconsequential but less than material, as total cash sales are less than material. Thus, this deficiency is at least a significant deficiency. However, because your client is a not-for-profit organization, because cash is a sensitive area, and because fraud is involved, you step back and try to look at this situation from a prudent official's perspective. You consider how a regulator may view this, how a donor may view this, and how others in the nonprofit community may view this. In doing that, your judgment is that a prudent official would probably view an absence of controls over cash receipts as a material weakness. Therefore, you conclude that this is a material weakness.

Control Deficiency 6: Control Testing Exceptions

Situation 11

In performing tests of controls during the audit, you identify an exception. You determined that the exception was one of numerous internal control exceptions that occurred during the two weeks that the controller was on vacation. Controls operated effectively before he left and after he returned to work. No misstatements in the financial statements were identified relating to that period of time.

Discussion. You first need to determine whether the control testing exception is a control deficiency before considering the severity of that control deficiency. Effective internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting. Because effective internal control over financial reporting cannot and does not provide absolute assurance of achieving financial reporting objectives, any individual control does not necessarily have to operate perfectly, all the time, to be considered effective. You may want to gather additional evidence, beyond what you had initially planned and beyond inquiry, to support your conclusion that the exception does not represent a control deficiency. You cannot use the lack of actual misstatements to lessen the severity of the control deficiency in your determination, because you have to consider *potential* misstatements of any magnitude. Factors to consider in making your determination would include complementary, redundant, or compensating controls, which could include the monitoring activities undertaken by the controller upon returning from vacation.

Resource Central

Publications

The following publications deliver valuable guidance and practical assistance related to internal control:

- *Assessing and Responding to Audit Risk in a Financial Statement Audit* (product no. 012456) (Expected to be available in December 2006), a cornerstone AICPA audit guide encompassing and updating the existing AICPA audit guide, *Consideration of Internal Control in a Financial Statement Audit*, and encompassing the new "Risk Assessment" standards (SAS No. 104–No. 111). This guide illustrates how to gather the information needed to assess risk, evaluate that information to assess risks at the assertion level, and design and perform further audit procedures based on those assessed risks, evaluate the results, and reach conclusions.

- *Internal Control—Integrated Framework* (product no. 990012kk), a paperbound version of the COSO report that established a common definition of internal control different parties can use to assess and improve their control systems. It also includes information on how to prepare external reports and five tools for evaluating each of the components identified in the framework.

- *Financial Reporting Fraud: A Practical Guide to Detection and Internal Control* (product no. 029879kk), a paperbound publication for CPAs in both public practice and industry. It uses case studies to provide information necessary to minimize fraud exposure for CPAs, employers, and clients.

- *Audit Committee Toolkit* (product no. 991001kk), a practice aid that brings you checklists, matrixes, questionnaires, and other materials that are designed to help the audit committee do the job it needs to do.

Guidance for Audit Committees on the Risk of Fraud From Management Override of Internal Control

The AICPA Antifraud Programs and Controls Task Force has issued a document entitled *Management Override of Internal Controls: The Achilles' Heel of Fraud Prevention—The Audit Committee and Oversight of Financial Reporting*. The document offers assistance to audit committees in addressing the risk of fraud arising from management override of internal control over financial reporting. The guidance contains the following major sections:

- "Management Override and the Audit Committee's Responsibilities"

- "Actions to Address the Risk of Management Override of Internal Controls"

- "Suggested Audit Committee Procedures: Strengthening Knowledge of the Business and Related Financial Statement Risks" (Appendix)

The following are some of the topics related to audit committees that are covered in the document:

- Maintaining an appropriate level of skepticism

- Strengthening the audit committee's understanding of the business

- Brainstorming to identify fraud risks

- Using the code of conduct to assess financial reporting culture
- Cultivating a vigorous whistle-blower program
- Developing a broad information and feedback network including communications with internal auditors, independent auditors, compensation committee, and key employees

The document can be downloaded from the "Spotlight Area" on the AICPA's Audit Committee Effectiveness Center Web page at www.aicpa.org/audcommctr/homepage.htm.

AICPA's reSOURCE Online Accounting and Auditing Literature

Get access—anytime, anywhere—to the AICPA's latest *Professional Standards*, Technical Practice Aids, Audit and Accounting Guides, Audit Risk Alerts, and *Accounting Trends & Techniques*. To subscribe to this essential service, go to www.cpa2biz.com.

reSOURCE CD-ROM

The AICPA offers a CD-ROM product entitled *reSource: AICPA's Accounting and Auditing Literature*. This CD-ROM enables subscription access to AICPA Professional Literature products in a Windows format, namely, *Professional Standards*, Technical Practice Aids, and Audit and Accounting Guides (available for purchase as a set or as individual publications). This dynamic product allows you to purchase the specific titles you need and includes hypertext links to references within and between all products.

Educational Courses and Training

Among its numerous continuing professional education (CPE) courses about internal control, the AICPA offers the following products. Information about additional AICPA internal control-related CPE courses can be obtained at www.cpa2biz.com:

- *Internal Control and IT: Reliable Reporting and Fraud Prevention*, a CPE course that provides an overview of the key auditing standards, conceptual frameworks, IT infrastructures and auditing issues you are likely to face on medium to small company engagements. (Product no. 732551)

- *Internal Controls: Design and Documentation*, a basic course that explains what makes up an effective system and provides a toolkit of today's current techniques for creating useful documentation. This course will benefit controllers, managers, and internal auditors in businesses as well as auditors and consultants to public and private companies who need a review. (Product no. 731852)

Online CPE

AICPA *CPExpress*, offered exclusively through CPA2Biz.com, is the AICPA's flagship online learning product with enhancements such as a new user interface and improved functionality. AICPA *CPExpress* now offers a free trial subscription to the entire product for up to 30 days. AICPA members pay $149 ($369 nonmembers) for a new subscription and $119 ($319 nonmembers) for the annual renewal. Divided into one- and two-credit courses that are available 24/7, AICPA *CPExpress* offers hundreds of hours of learning in a wide variety of topics. To register or learn more, visit www.cpa2biz.com.

AICPA's Antifraud & Corporate Responsibility Resource Center

The AICPA's Antifraud & Corporate Responsibility Resource Center (www.aicpa.org/antifraud/) allows you to select optional ways to learn about fraud. The Center spotlights the new Web-based fraud and ethics case studies and commentaries recently issued; the AICPA antifraud Webcast series; the interactive CPA course *Fraud and the CPA*; and a competency model that allows you to assess your overall skills and proficiencies as they relate to fraud prevention, detection, and investigation, among other topics. In addition, the site offers press releases and newsworthy items on other AICPA courses related to prevention and detection and an overview of the AICPA Antifraud & Corporate Responsibility Program.

AICPA Audit Committee Effectiveness Center

Located at www.aicpa.org/audcommctr/homepage.htm, the AICPA Audit Committee Effectiveness Center presents the guidance and tools necessary to make audit committee best practices actionable. Available at the center is the AICPA Audit Committee Toolkit, the Audit Committee Matching System, Audit Committee e-Alerts, and other guidance and resources.

AICPA Audit Quality Centers

Governmental Audit Quality Center (GAQC)

The GAQC, which is designed to improve the quality of governmental audits, provides firm members with a set of best practices and tools in the specialized area of governmental auditing, including Yellow Book and Circular A-133 audits. It also includes a comprehensive Web site at www.aicpa.org/GAQC.

Employee Benefit Plan Audit Quality Center

The AICPA Employee Benefit Plan Audit Quality Center is intended to provide a forum that spurs CPA firms performing audits to make immediate quality improvements to employee benefit audits under the Employee Retirement Income Security Act of 1974 (ERISA), including pension, health and welfare, and 401(k) plans. In addition to gaining access to best practices, guidelines, and tools focused around quality improvement, members of the Center are subject to membership requirements that demonstrate the firm's commitment to audit quality in this area. Additional information about the Center can be found at www.aicpa.org/ebpaqc.

Order Department (Service Center Operations)

To order AICPA products, call the AICPA Member Service Center at (888) 777-7077 or fax to (800) 362-5066. The best times to call are 8:30 a.m. to 11:30 a.m. and 2:00 p.m. to 7:30 p.m., Eastern Standard Time. Also, visit the CPA2Biz Web site at www.cpa2biz.com to obtain product information and place online orders.

Hotlines

Accounting and Auditing Technical Hotline

The AICPA Technical Hotline answers members' inquiries about accounting, auditing, attestation, compilation, and review services. Call (888) 777-7077.

Ethics Hotline

Members of the AICPA's Professional Ethics Team answer inquiries concerning independence and other behavioral issues related to the application of the AICPA Code of Professional Conduct. Call (888) 777-7077.

Web Sites

AICPA Online and CPA2Biz

AICPA Online (www.aicpa.org) offers CPAs the unique opportunity to stay abreast of matters relevant to the CPA profession. AICPA Online informs you of developments in the accounting and auditing world as well as developments in congressional and political affairs affecting CPAs. In addition, www.cpa2biz.com offers all the latest AICPA products, including the Audit and Accounting Guides, the professional standards, CPE courses, practice aids, and alerts.

••••••••

As you encounter audit or industry issues that you believe warrant discussion in the Audit Risk Alert *Understanding SAS No. 112 and Evaluating Control Deficiencies*, please feel free to share them with us. Any other comments you have about the Alert would be appreciated. Based on comments received, the Alert may be revised in the future. You may e-mail these comments to agoldman@aicpa.org or write to:

Ahava Goldman, CPA
AICPA
1211 Avenue of the Americas
New York, NY 10036

AICPA Member and
Public Information:
www.aicpa.org

AICPA Online Store:
www.cpa2biz.com

ISO Certified

022536